Supreme Court of the United States

OCTOBER TERM, 1935

No. 859

C. L. ASHTON, *et al.*,

Petitioners,

vs.

CAMERON COUNTY WATER IMPROVEMENT DISTRICT NO. ONE,

Respondent.

BRIEF OF RESPONDENT

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INDEX

	PAGE
Statement	1
Argument	2
The Act is a Bankruptcy Act	3
The Act is a Uniform Law Upon the Subject of Bankruptcies Throughout the United States	4
The Act Does Not Violate the Fifth Amendment to the Constitution of the United States	6
The Act Does Not Invade the Sovereignty of the States in Violation of the Tenth Amendment to the Constitution of the United States	7
The Municipal Bankruptcy Act Does Not Violate Section 10 of Article I of the Constitution of the United States, Nor Section 16 of Article I of the Constitution of Texas	13
The Validity of the Contract Made Between the District and the Reconstruction Finance Corporation Cannot be Attacked in This Appeal	17
Conclusion	18

TABLE OF CASES.

	PAGE
Ackley School District *v.* Hall, 113 U. S. 135	14
Bernards Township *v.* Morrison, 133 U. S. 523	14
Blair *v.* West Point Precinct, 5 Fed. 265	12
Broughton *v.* Pensacola, 93 U. S. 266	11
Continental Bank *v.* Rock Island Railway, 294 U. S. 648	3, 6, 7
Dean *v.* Davis, 51 Cal. 406	12
Fallbrook Irrigation Dist. *v.* Bradley, 164 U. S. 112	14
Hanover National Bank *v.* Moyses, 186 U. S. 181	5
Heine *v.* Levee Commissioners, 19 Wall. 655	14
Houck *v.* Little River Drainage Dist., 239 U. S. 254	14
Jordan *v.* Case County, 3 Dillon 185	12
King *v.* Harbor Board, 57 Ala. 135	12
Leidigh Carriage Co. *v.* Stengel, 95 Fed. 637	5
Levy Court *v.* Coroner, 2 Wall. 501	12
Lincoln County *v.* Luning, 133 U. S. 5	9, 13
Louisville Joint Stock Land Bank *v.* Radford, 295 U. S. 555	3, 7
Mahoney *v.* Bank of State, 4 Ark. 620	12
Mobile *v.* Watson, 116 U. S. 289	11
Mount Pleasant *v.* Beckwith, 100 U. S. 514	11
Norton *v.* Taxing District of Brownsville, 129 U. S. 479	14
Orr *v.* Allen, 248 U. S. 35	14
Pollock *v.* Farmers Loan & Trust Co., 157 U. S. 429, 158 U. S. 601	10
Rosencranz *v.* Evansville, 43 N. E. 593	12
School District *v.* Insurance Co., 103 U. S. 707	12
Willcutts, Collector, *v.* Bunn, 282 U. S. 216	10

CONSTITUTION OF UNITED STATES.

PAGE

Art. I, Sec. 8, Subdivision 4..... 2, 3, 6
Art. I, Sec. 10, Subdivision 1.....2, 14, 17

STATUTES.

Bankruptcy Act, Sec. 77.....3, 7, 16
Bankruptcy Act, Sec. 80..... 3
Bankruptcy Act, Sec. 80, Subdivision (c)..... 18
Bankruptcy Act, Sec. 80, Subdivision (k)..... 4
Constitution of Texas, Art. I, Sec. 16.....2, 13, 14, 17

TEXTBOOKS.

Cooley on Constitutional Limitations, 8th Edition, Vol. 1, p. 411..... 12
Dillon on Municipal Corporations, 5th Edition, Vol. 1, p. 120..... 12

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CAMERON COUNTY WATER IMPROVEMENT DISTRICT NO. ONE,

Respondent.

BRIEF OF RESPONDENT.

This appeal presents to this Honorable Court for decision, the question of the constitutionality of Section 80 of the Bankruptcy Act, generally known as the Municipal Bankruptcy Act. The act has been held constitutional by a great many District Judges. The only adverse decision regarding its constitutionality of which we are aware, was that rendered in this case in the District Court for the Southern District of Texas, which decision was reversed by the Circuit Court of Appeals of the Fifth Circuit. From this last mentioned decision, the petitioners appeal to this Honorable Court.

Argument.

An analysis of the brief of the petitioners would indicate that the following points regarding the constitutionality of the statute are presented for decision by this Court:

1. Is the act a bankruptcy act within the meaning of Subdivision 4, Sec. 8, Art. I of the Constitution of the United States?

2. Is the act a uniform law upon the subject of bankruptcies throughout the United States?

3. Does the act violate the Fifth Amendment to the Federal Constitution?

4. Does the act invade the sovereignty of the States in violation of the Tenth Amendment to the Constitution of the United States?

5. Does the act violate Subdivision 1 of Section 10 of Article I of the Constitution of the United States, and Section 16 of Article I of the Constitution of the State of Texas by impairing the obligation of contracts?

We will consider these points in that order.

The Act is a Bankruptcy Act.

The provisions of the act before the Court are so similar to the provisions of Section 77 of the Bankruptcy Act that we consider the decision of this Court in *Continental Bank* v. *Rock Island Railway,* 294 U. S. 648, disposes of any question that the act is a bankruptcy act, within the meaning of Subdivision 4, Section 8, Article I of the Constitution of the United States. The statute before the Court in this case, like that considered in *Continental Bank* v. *Rock Island Railway, supra,* is a composition act. To quote the language of Mr. Justice Sutherland in that decision:

> "Both contemplate an adjustment of a failing debtor's obligations; and although actual bankruptcy may not supervene in either, they are none the less laws on the subject of bankruptcies."

In view of the fact that the decision in *Continental Bank* v. *Rock Island Railway, supra,* was rendered so recently, and the statute then before the Court is so familiar to the members of this Honorable Court, we will not impose upon the time of the Court to compare the provisions of Section 77 of the Bankruptcy Act with the provisions of Section 80 of the same statute, which is now before the Court in this case. It is sufficient to say that they are substantially alike. They both provide for a proceeding in the United States District Court for the composition of the debts of an insolvent debtor pursuant to an agreement reached with the holders of a majority in amount of the outstanding obligations of the debtor.

The statute before the Court in this case, like Section 77 of the Bankruptcy Act, is distinguishable from the act before this Court in *Louisville Joint Stock Land Bank* v. *Radford,* 295 U. S. 555, in that it is a composition act. This distinction was pointed out by Mr. Justice Brandeis

in delivering the opinion of the Court in that case. He said:

> "Nor do the provisions of the bankruptcy acts concerning compositions afford any analogy to the provisions of Paragraph 7. So far as concerns the debtor, the composition is an agreement with the creditors in lieu of a distribution of the property in bankruptcy—an agreement which 'originates in a voluntary offer by the bankrupt, and results in the main, from voluntary acceptance by his creditors.' * * * So far as concerns dissenting creditors, the composition is a method of adjusting among creditors rights in property in which all are interested. In ordering the adjustment, the bankruptcy court exercises a power similar to that long exercised by courts of law, * * * and of admiralty. * * * It is the same power, which a court of equity exercises when it compels dissenting creditors, in effect, to submit to a plan of reorganization approved by it as beneficial and assented to by the requisite majority of the creditors."

We respectfully submit that in view of these decisions there can be no doubt that the act before the Court in this case is a bankruptcy act.

The Act is a Uniform Law Upon the Subject of Bankruptcies Throughout the United States.

The petitioners contend that there is a lack of uniformity in the application of the Municipal Bankruptcy Act. They base their contention upon the provisions of Subdivision (k) of Section 80 of the statute. They assert that the provisions of this subdivision indicate that the act does not apply to political subdivisions of States which have established fiscal agencies exercising authority over such subdivisions, unless such fiscal agencies consent to the filing of the petition, and that the act does not purport to apply to political subdivisions of States which pass

legislation requiring the approval of an agency of the State of the filing of the petition, unless such approval is obtained. We wish to point out to the Court that there is nothing in the provisions of Subdivision K of the Act providing that the act is inapplicable in any State. That subdivision merely recognizes the fact that the taxing districts, to which the act is applicable, are not free agents, and provides that in those States in which there are State agencies authorized to exercise supervision or control over the fiscal affairs of the taxing districts, the petition may not be received by the District Court, unless accompanied by the written approval of such State agency. In short, the act creates a special class of petitioners and modifies slightly the procedure, incident to the filing of a petition under the act, in the case of members of that class. It is intended merely to prevent the filing of a petition in the District Court of the United States by a petitioner which has not complied with all the formalities, required by the laws of the State in which it is located, to authorize it to do so.

This Court has repeatedly held that the uniformity required of a bankruptcy act, to conform to the Constitution of the United States, is geographic and not personal in the sense of being alike applicable to all members of the community. *Hanover National Bank* v. *Moyses*, 186 U. S. 181; *Leidigh Carriage Co.* v. *Stengel*, 95 Fed. 637.

The fact, therefore, that the Municipal Bankruptcy Act requires a taxing district to comply with the laws of the State in which it is located, requiring the approval of the petition by a State agency, does not destroy the geographic uniformity of the act but merely creates a class of petitioners, required to comply with certain formalities prior to the filing of the petition with the District Court, which are not required of other petitioners, which are not members of the class.

The power of Congress to classify persons who may take advantage of bankruptcy acts is so well settled that

it will hardly admit of controversy. The various changes in the classification of persons, entitled to take advantage of bankruptcy laws of the United States, are set forth in great detail by Mr. Justice Sutherland, in *Continental Bank* v. *Rock Island Railway, supra.* We respectfully submit, therefore, that the classification of taxing districts set forth in Subdivision K of the Municipal Bankruptcy Act does not violate the geographic uniformity required of a bankruptcy law by Subdivision 4, Section 8, Article I of the Constitution of the United States.

The Act Does Not Violate the Fifth Amendment to the Constitution of the United States.

The petitioners contend that the Municipal Bankruptcy Act violates the Fifth Amendment to the Federal Constitution. They assert that the bankruptcy power is subject to the provisions of the Fifth Amendment, prohibiting the deprivation of persons of their property without due process of law. No doubt that is so, but this Court said in *Continental Bank* v. *Rock Island Railway, supra:*

> "The Constitution, as it many times has been pointed out, does not in terms prohibit Congress from impairing the obligation of contracts as it does the states. * * * Speaking generally, it may be said that Congress, while without power to impair the obligation of contracts by laws acting directly and independently to that end, undeniably, has authority to pass legislation pertinent to any of the powers conferred by the Constitution, however it may operate collaterally or incidentally to impair or destroy the obligation of private contracts. * * * And under the express power to pass uniform laws on the subject of bankruptcies, the legislation is valid though drawn with the direct aim and effect of relieving insolvent persons in whole or in part from the payment of their debts."

In *Louisville Joint Stock Land Bank* v. *Radford, supra,* cited by petitioners in support of their contention, Mr. Justice Brandeis, in rendering the opinion of the Court, recognized the principle embodied in the above quotation, when he said:

> "But the effect of the act here complained of is not the discharge of Radford's personal obligation. It is the taking of substantive rights in specific property acquired by the Bank prior to the Act."

The act before the Court in that case was not a composition act. The consent of the creditor or creditors to a plan of composition was not required. The adjustment of the indebtedness of the bankrupt was intended to be accomplished without the consent of creditors. The element of composition being lacking, it may well be doubted whether the Frazier-Lemke Act, which this Court held unconstitutional in that case, is a bankruptcy act at all.

The Municipal Bankruptcy Act is so dissimilar from the Frazier-Lemke Act and so similar to Section 77 of the Bankruptcy Act that the decision in *Louisville Joint Stock Land Bank* v. *Radford* is not applicable, and the case which is in point is *Continental Bank* v. *Rock Island Railway, supra.*

The Act Does Not Invade the Sovereignty of the States in Violation of the Tenth Amendment to the Constitution of the United States.

The reasons for the enactment of the Municipal Bankruptcy Act were identical with those which motivated Congress in enacting Section 77 of the Bankruptcy Act, applicable to railroad corporations. The public corporations, being unable to meet their obligations at maturity, found that their outstanding bonds, notes and other evidences of indebtedness were held by large numbers of persons. Usually they found it possible to enter into agreements

with the holders of the great majority of these obligations for an extension of the indebtedness, or for an adjustment of the principal or interest of the obligations, or both. Almost invariably, however, they were unable to reach similar agreements with the holders of comparatively small amounts of these obligations, and these adjustments, for that reason, were frequently frustrated. There was no law under which the minority could be bound by an agreement entered into by the holders of the great majority in amount of the outstanding obligations. The result was that Congress was petitioned, not only by the municipalities but by creditor interests, to enact legislation under the bankruptcy powers vested in it by the Constitution of the United States, to substitute the democratic principle of majority rule for the virtual anarchy which then existed with reference to the adjustment of the debts of insolvent municipal corporations and taxing districts.

The Municipal Bankruptcy Act was enacted by Congress to meet this situation. There was no intention upon the part of Congress to extend the powers of the Federal courts over the taxing districts. No extension of such powers was necessary to meet the situation. The powers of the Federal courts with reference to the enforcement of the defaulted municipal obligations was deemed to be adequate. Let us take a moment to consider what these powers were and still are.

The holder of a bond issued by a municipal corporation or taxing district of any of the States, if the requisite ground for Federal jurisdiction existed, was entitled to bring a suit in the United States District Court against the municipality or taxing district and obtain a judgment for the amount due, or principal or interest or both. The Court was empowered to require the municipality or taxing district to answer the complaint of the bondholder, and the officials of the municipality or taxing district could be subpœnaed to testify in the case and required to

bring with them the minute books and other records of the municipality for examination by the plaintiff.

Having rendered a judgment in favor of the plaintiff upon the defaulted securities, the Court was empowered, upon application of the judgment creditor, to issue a writ of mandamus directed to the municipality or taxing district and its governing body and other officers, requiring them to levy taxes, in the manner provided by the laws under which the obligations were issued, for the payment of the judgment under penalty of being committed for contempt of court.

For generations Federal courts, including this Honorable Court, have entertained suits of this character for the enforcement of the defaulted obligations of cities, towns, counties, townships, school districts and other districts of every conceivable variety. It has never been considered that these powers were invasions of the sovereignty of the respective States. In *Lincoln County* v. *Luning*, 133 U. S. 5, it was contended that the Eleventh Amendment prohibited suits against counties in a Federal court. That contention was expressly denied by this Court, and it has never been questioned, since that time, that the Eleventh Amendment prohibits only suits against the State itself.

The extension of the jurisdiction of the Federal courts by the Municipal Bankruptcy Act, therefore, *was an extension of jurisdiction over creditors.* The Court was given no additional jurisdiction over the municipality or taxing district. It was merely authorized to enter a decree, the effect of which was to require minority creditors to accept a composition, agreed upon by the holders of the requisite majority in amount of the obligations affected by the plan. So far as secured claims are concerned they could be effected by the decree only when the holder of the secured claim was a member of a class, and then only when the composition was desired by the requisite majority of the class and approved by the Court. No power vested in the

Federal Court by the Municipal Bankruptcy Act, which might be exercised against the municipality or taxing district, can be pointed to which the Court did not possess prior to the enactment of that statute.

The act merely gave municipalities and taxing districts the right to institute a proceeding in the Federal courts, which they did not theretofore possess. No bankruptcy proceeding can be instituted under the act against any municipality or taxing district by creditors. The proceeding must be instituted by the municipality itself. We fail to see how the extension of a right, which may or may not be availed of at the option of the municipality or taxing district, can be construed as an invasion of the sovereignty of the States.

We respectfully submit that the cases cited by the petitioners in their brief are not in point. We recognize that the Courts of Texas and the Federal courts have sustained the right of a bondholder to compel the collection of taxes by the municipality issuing the bonds in order to provide for their payment, and that the bondholders have a right to rely upon the performance of such obligations, but these are rights of private individuals, not the prerogatives of the sovereign. We also admit that the Federal courts cannot interfere with the control of the States over the fiscal affairs of their municipalities, with this qualification,—that they may require such municipalities to perform their contracts. No attempt is made by the Municipal Bankruptcy Act, however, to control the fiscal affairs of the municipalities or taxing districts of the States. The act does no more than require a minority of creditors to accept a composition, tendered by the municipality, which has received the approval of the requisite majority of the creditors.

The decisions cited by the petitioners, such as *Pollock* v. *Farmers Loan & Trust Co.*, 157 U. S. 429; 158 U. S. 601; *Willcutts, Collector,* v. *Bunn,* 282 U. S. 216, etc., involving the right of the United States to levy taxes upon

municipal bonds or the income derived therefrom, obviously are not in point. The *issuance* of municipal bonds is an exercise of one of the sovereign powers of the States, to-wit, the contracting power. This Court has repeatedly held that a tax upon a municipal bond or the income derived therefrom falls upon the borrower, and is in reality a tax upon the exercise of the borrowing power of the State. We are heartily in accord with these decisions, but they all relate to the exercise of powers directed against municipalities or the States in which they are located. There are no comparable provisions of the Municipal Bankruptcy Act. In short, the Municipal Bankruptcy Act deals solely with the adjustment of the indebtedness of insolvent corporations. Taxing districts, to which the act is applicable, notwithstanding their public character, are corporations, with entities distinct from that of the State. In their relations with creditors they are treated by the Courts for all practical purposes as corporations. In *Broughton* v. *Pensacola*, 93 U. S. 266, this Court said:

> "Although a municipal corporation, so far as it is invested with subordinate legislative powers for local purposes, is a mere instrumentality of the State for the convenient administration of Government, yet, when authorized to take stock in a railroad company, and issue its obligations in payment of the stock, it is to that extent to be deemed a private corporation, and its obligations are secured by all the guaranties which protect the engagements of private individuals."

This language was approved in *Mount Pleasant* v. *Beckwith*, 100 U. S. 514, and in *Mobile* v. *Watson*, 116 U. S. 289. It may be contended, however, that many of these taxing districts are not corporations and that there is no statute either declaring them to be corporations or conferring upon them the power to sue or be sued. No particular form of words, however, is required to create a public corporation. Intent to create a corporation, or a

quasi corporation, may be implied from the powers which are conferred upon a group of individuals.

Cooley on Constitutional Limitations, 8th Edition, Vol. 1, p. 411;
Dillon on Municipal Corporations, 5th Edition, Vol. 1, p. 120;
Mahoney v. *Bank of State*, 4 Ark. 620;
Rosencranz v. *Evansville*, 43 N. E. 593;
Dean v. *Davis*, 51 Cal. 406;
Jordan v. *Case County*, 3 Dillon 185;
Blair v. *West Point Precinct*, 5 Fed. 265;
King v. *Harbor Board*, 57 Ala. 135;
School District v. *Insurance Co.*, 103 U. S. 707;
Levy Court v. *Coroner*, 2 Wall. 501.

When the Legislature of a State creates a political subdivision and vests in the governing body of that subdivision the power to issue bonds in its own name or on its behalf, by so doing the State vests in that political subdivision the attributes of a corporation, with power to sue and be sued with respect to the contracts which it makes on the bonds and in relation to them.

The Municipal Bankruptcy Act merely undertakes to permit these corporations to enter into composition agreements with the majority of their creditors and to file a petition in the United States District Court praying for a decree making that composition binding upon all creditors. It is difficult to see in what respect such a statute invades the sovereign powers of the States.

The Municipal Bankruptcy Act Does Not Violate Section 10 of Article I of the Constitution of the United States, Nor Section 16 of Article I of the Constitution of Texas.

In support of their contention that the Municipal Bankruptcy Act violates Section 10 of Article I of the Constitution of the United States and Section 16 of Article I of the Constitution of Texas, petitioners cite an opinion, prepared by Special Assistant Attorney General Weston, which was transmitted by the Attorney General of the United States to the House Judiciary Committee when the Municipal Bankruptcy Act was under consideration there. In that opinion an attempt is made to distinguish between true municipal corporations and "political subdivisions which are merely departments or branches of the State Government". We submit that there is no basis for any distinction between true municipal corporations, such as cities and towns, and any other political subdivision of a State, which is a corporation distinct from the State, having the power to issue bonds in its own name or on its behalf, which are not the obligations of the State itself. Such subdivisions, like Cameron County Water Improvement District No. 1, are not merely departments or branches of the State Government. They have an entity entirely distinct from that of the State which created them. Were this not so then no suits could be brought against them without the consent of the State. Such suits would be prohibited by the Eleventh Amendment to the Constitution of the United States, but as above pointed out, this Court has held in *Lincoln County* v. *Luning, supra,* that the Eleventh Amendment does not prohibit such a suit against a county, and literally hundreds of suits brought upon bonds issued by counties, school districts, drainage districts, irrigation districts and

similar political subdivisions of the States, have been reviewed by this Court during the past one hundred years. The decisions of this Court in some of these suits are among the most important rulings in the municipal law of the United States. We need but refer to such cases as,

Bernards Township v. *Morrison*, 133 U. S. 523;
Ackley School District v. *Hall*, 113 U. S. 135;
Fallbrook Irrigation Dist. v. *Bradley*, 164 U. S. 112;
Houck v. *Little River Drainage Dist.*, 239 U. S. 254;
Heine v. *Levee Commissioners*, 19 Wall. 655;
Norton v. *Taxing District of Brownsville*, 129 U. S. 479;
Orr v. *Allen*, 248 U. S. 35.

It is rather late to question the jurisdiction of the Federal courts over these political subdivisions and taxing districts so far as concerns the contractual obligations they have incurred to private citizens.

As we understand the reasoning of the petitioners upon this point, they contend that the Municipal Bankruptcy Act is inoperative without concurrent legislation upon the part of the States expressly authorizing their municipalities and taxing districts to take advantage of the Municipal Bankruptcy Act, and that such State legislation impairs the obligation of contracts in violation of Subdivision 1 of Section 10 of Article I of the Constitution of the United States, and the similar prohibition contained in Section 16 of Article I of the Constitution of Texas. This argument proceeds upon the *assumption* that such State legislation is necessary. No reason is assigned for this assumption, and we do not admit its validity.

As we have previously pointed out, when a State authorizes one of its political subdivisions to issue bonds in its own name, it vests in that district the attributes of a corporation, with power to sue and to be sued. A political

subdivision authorized to issue bonds would certainly have the power to bring suit against a purchaser of the bonds for damages for failure to perform his contract or for the cancellation of the bonds, if they were illegally issued. It would even possess the right to file a claim in bankruptcy against a bankrupt if such a claim should arise out of the transaction. We submit that such a corporation possesses the right to resort to any judicial proceeding permitted by the laws of the States or of the United States with reference to any claim or right asserted to have arisen out of the transaction, and that this right is not limited to those proceedings or procedures which may have been authorized at the time it issued the bonds, but extends to any judicial proceeding permitted by the laws of the United States or of the respective States at the time the action is taken.

We think it would hardly be questioned that in any dispute arising between a municipality and its creditors it would have the right to participate in a proceeding for a declaratory judgment in the Federal courts, notwithstanding the fact that until quite recently no such proceeding was authorized by the Federal statutes, and even though no statute existed expressly authorizing the municipality to file a proceeding for a declaratory judgment. This district is authorized, by express statutes of the State of Texas, to sue or be sued, and we respectfully submit that such power vests in the district the right to institute any sort of judicial proceeding which might be available to it at any time under the laws of any State or of the United States for the determination of any controversy arising out of its contracts, and that such power expressly authorizes it to file a petition in bankruptcy when such a bankruptcy proceeding is authorized by the laws of the United States.

The argument that concurrent legislation on the part of the States is necessary seems to proceed upon the notion that the Municipal Bankruptcy Act is an invasion of the

sovereignty of the States, and, therefore, the several States must affirmatively give their consent to its provisions before the act can be applicable to their municipalities. No other reason for the necessity for such concurrent legislation is given or even hinted at in the petitioners' brief.

We believe, however, that we have demonstrated that the Municipal Bankruptcy Law does not involve any invasion of the sovereignties of the States, and, that being so, we can conceive of no more reason for the enactment of legislation by the States, expressly authorizing a municipal corporation to file a petition under the Municipal Bankruptcy Law, than for similar legislation authorizing a railroad corporation to file a petition in bankruptcy under the provisions of Section 77 of the Bankruptcy Act.

But even assuming such concurrent legislation were necessary, such acts of the States consenting to the filing of bankruptcy petitions by municipalities and taxing districts would not constitute acts in violation of the obligation of contract. The right to file a petition in bankruptcy can only be conferred by Congress. The decree of a United States District Court confirming a composition in bankruptcy can only be rendered under the authority of an Act of Congress. If there is any impairment of the obligation of contracts, therefore, the act which impairs the obligation is the act of Congress, and there is no prohibition against the enactment by Congress of a bankruptcy act, which has the effect of impairing the contractual obligations.

The impairment of the contract does not flow from the act of the State legislation. Such a statute would merely authorize the municipalities to present a petition to the United States District Court. The consequences which would follow from the filing of that petition would not derive from the act of the State Legislature but from a decree of the District Court, if any were rendered in

the proceeding, which would depend for its validity not upon the State legislation but upon the act of Congress.

The Circuit Court of Appeals held that concurrent legislation by the State was not necessary. We believe that decision to be correct, but we submit that even if such concurrent legislation on the part of the State were necessary, such legislation would not impair the obligation of contracts in violation of Section 10 of Article I of the Constitution of the United States, or Section 16 of Article I of the Constitution of Texas.

The Validity of the Contract Made Between the District and the Reconstruction Finance Corporation Cannot be Attacked in This Appeal.

The petitioners attack the validity of the loan contract between the District and the Reconstruction Finance Corporation. The ground upon which they base their attack is that under the provisions of subdivision (e) of Section 80 of the Bankruptcy Law, the District Judge shall confirm the plan only if satisfied that

> "the taxing district is authorized by law, upon confirmation of the plan, to take all action necessary to carry out the plan."

Petitioners contend that the District is not authorized by law to carry out all of the provisions of the contract entered into with the Reconstruction Finance Corporation.

No such objection, however, was made in the District Court, and we submit that it cannot now be raised in this Court. The District Court dismissed the petition for want of jurisdiction. The question to be decided by this Honorable Court is whether the District Judge ruled correctly in this respect. The merits of the refunding plan, or defects in it, were not involved in the order of dismissal. They were matters which might be raised upon

the hearing provided for by subdivision (c) of Section 80. If at the hearing, petitioners were able to demonstrate that the plan was defective, unfair or contained illegal provisions, all of these objections might possibly be disposed of by appropriate amendments or modifications of the plan.

Inasmuch as the proceeding never reached the stage of a hearing upon the merits of the plan, we respectfully submit that the legality of the contract made between the District and the Reconstruction Finance Corporation, the power of the District to carry out the contract, or the constitutional right of the Corporation to make the loan, are not properly before this Honorable Court.

Conclusion.

In conclusion, we submit that the Municipal Bankruptcy Act is valid legislation, and that the decision of the United States Circuit Court of Appeals should be affirmed.

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